Supreme Court, U.S.
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No.

In the
Supreme Court of the United States

WILLIAM C. WITZEL and GENE E. WITZEL,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

When a subchapter S corporation realizes cancellation of debt income ("COD income") pursuant to a reorganization under Chapter 11 of the Bankruptcy Code, and excludes it from gross income pursuant to 26 U.S.C. § 108(a):

1. Is the COD income that is excluded at the corporate level an item of "income" under 26 U.S.C. § 1366 (permitting pass through of income and loss) which results in an increase in basis pursuant to 26 U.S.C. § 1367(a) (increasing basis for all income passed through to subchapter S shareholders pursuant to § 1366)?

2. Does 26 U.S.C. § 108(b)(4)(A), which provides that tax attribute reduction "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge [of COD income]," permit the subchapter S shareholders to deduct losses that were previously suspended due to insufficient basis before attributes are reduced at the corporate level?

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners William C. and Gene E. Witzel respectfully request that this Court issue a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The Commissioner of Internal Revenue issued a Notice of Deficiency to Petitioners. (App. 22a) In a memorandum opinion reported at T.C. Memo. 1999-64, 77 T.C.M. (CCH) 1487 (1999), the Tax Court upheld the Commissioner's deficiency determination. (App. 8a) The U.S. Court of Appeals for the Seventh Circuit affirmed the Tax Court Decision in an opinion reported at *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000). (App. 1a)

JURISDICTION

The Court of Appeals entered judgment on January 18, 2000. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 108, 1366 and 1367 of the Internal Revenue Code of 1986 (Title 26 of the United States Code), are set forth in full at App. 25a, App. 38a and App. 41a, respectively.[1]

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[1] The Internal Revenue Code hereinafter may be referred to as the "Code." Section references are to the Code, unless otherwise noted.

26 U.S.C. §§ 1367(a)(1)(A), 1366(a)(1)(A), 108(a)(1)(A), and 108(b)(4)(A) provide, in relevant part:

> The basis of each shareholder's stock in an S corporation shall be increased for any period by *** the items of income described in subparagraph (A) of section 1366(a)(1). *See* § 1367(a)(1)(A).
>
> [T]here shall be taken into account the shareholder's pro rata share of the corporation's-(A) items of income (including tax-exempt income), loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder. § 1366(a)(1)(A).
>
> Gross income does not include any amount which [but for section 108(a)(1)] would be includible in gross income by reason of the discharge-(A) of indebtedness of the taxpayer if . . . the discharge occurs in a title 11 case. § 108(a)(1)(A).
>
> The reductions [in tax attributes] shall be made after the determination of the tax . . . for the taxable year of discharge. § 108(b)(4)(A).

STATEMENT OF THE CASE

A. RELEVANT FACTS

The facts are not in dispute, and are set out in the parties' Stipulation of Facts. (App. 12a) Petitioner William C. Witzel (collectively, with his spouse, the "Taxpayers") was the sole shareholder of Water Products Company of Illinois, Inc. ("WPC"), a corporation that elected to be taxed under subchapter S of the Internal Revenue Code. WPC realized cancellation of debt ("COD") income in 1992 in the amount of $5,404,323 as a result of its bankruptcy under Chapter 11 of

the United States Bankruptcy Code. Thus, under section 108(a) of the Code, WPC was entitled to exclude the entire amount of the canceled indebtedness from income.

On their 1992 tax return, pursuant to sections 1366 and 1367, the Taxpayers increased the basis in their WPC stock by the amount of COD income. This increase in basis permitted the Taxpayers to deduct individually their share of prior S corporation losses, which had been previously suspended under section 1366(d)(1) because such losses exceeded their basis in the stock of WPC. Such deduction resulted in a net operating loss carryover to 1993 in the amount of $2,549,251.

B. PROCEEDINGS IN THE U.S. TAX COURT

The Commissioner disallowed Petitioners' losses claimed on the 1993 return, asserting that a basis increase was unavailable under the relevant statutes. The Petitioners timely petitioned the United States Tax Court to review the proposed deficiencies. (App. 18a) The Tax Court's jurisdiction arose under 26 U.S.C. §§ 6212, 6213, 6214, and 7442. The Tax Court entered its Decision upholding the Commissioner on March 4, 1999. (App. 7a)

C. PROCEEDINGS IN THE COURT OF APPEALS

Petitioners timely filed notices of appeal on June 4, 1999, pursuant to Fed.R.App.P. Rule 13. The Court of Appeals, which had jurisdiction pursuant to 26 U.S.C. § 7482, affirmed the Tax Court's Decision, holding that COD income of an S corporation is offset against any existing suspended losses arising from the operation of the corporation. (App. 1a) The Court concluded that the allowance of the deduction of the suspended losses would create a "windfall" to Taxpayers, but also held, contrary to the Tax Court and the Tenth Circuit in *Gitlitz v. Commissioner of Internal Revenue*, 182 F.3d 1143

(10th Cir. 1999) that COD income does increase the shareholder's basis in his stock.

REASONS FOR GRANTING THE PETITION

I. The Court Of Appeals' Interpretation Of The Tax Code Requiring The Offset Of COD Income Against Any Existing Suspended Losses Conflicts With The Third Circuit's Interpretation, Is Based On Grounds Inconsistent With The Tenth Circuit's Interpretation, And Aggravates The Existing Split Of Authority In The District Courts And The Tax Court.

The Court of Appeals acknowledged that "the interpretive question could be resolved either way" in this case, but departed from the plain language of the Internal Revenue Code and decided in favor of the Commissioner in order to deny the Taxpayers a perceived "double windfall." (App. 4a) The Court failed, apparently, to consider the effect of the timing of attribute reduction prescribed by 26 U.S.C. §108(b)(4)(A). This lapse is striking, considering the fact that the Tenth Circuit in *Gitlitz v. Commissioner of Internal Revenue*, 182 F.3d 1143, 1148 (10th Cir. 1999) acknowledged that "the outcome of this case is ultimately determined by the timing of the pass-through", and the Third Circuit in *Farley v. United States*, 202 F.3d 198, 205 (3d Cir. 2000) stated that "the ultimate disposition of this case hinges on the interaction of Section 108(d)(7)(A) with Section 108(b)(4)(A)." The Court of Appeals' decision which, in effect, requires attribute reduction during the year of the discharge, rather than after, also conflicts with the Fifth Circuit's construction of that same statute in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 62 F.3d 398 (5th Cir. 1995), *aff'g and adopting the opinion of the Tax Court*, 103 T.C. 398 (1994).

The federal courts that have addressed the effect of S corporation excluded COD income upon shareholder stock basis have reached sometimes contradictory conclusions, and even courts reaching the same ultimate result have frequently employed inconsistent statutory interpretations in arriving at their conclusions. The Tax Court held for the government and disallowed both the deduction of the suspended losses and the increase in basis in *Nelson v. Commissioner*, 110 T.C. 114 (1998), on grounds that were subsequently rejected by the Tenth Circuit in *Gitlitz*, 182 F.3d at 1148, and *Nelson*, 182 F.3d 1152 (10th Cir. 1999). The Third Circuit in *Farley* rejected the reasoning of both the Tax Court (202 F.3d at 210) and the Tenth Circuit (202 F.3d at 205 fn. 4) *and* held for the taxpayer, allowing the deduction of the suspended losses and the increase in basis. Blazing yet another trail, the Court of Appeals for the Seventh Circuit has now disallowed the deduction of the suspended losses but *allowed* the increase in basis. *Witzel*, 200 F.3d at 495. In addition, a district court in Oregon recently held for the taxpayers for reasons similar to those set out in this Petition and in *Farley*. *See Hogue v. United States*, 2000 WL 2651 (D. Ore. January 3, 2000).

This conflict affects a significant number of insolvent corporations and their shareholders, many of whose tax cases are pending in Courts of Appeals or other courts throughout the nation.[2] Accordingly, a decision by this Court is necessary to

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[2] Pending cases in the Courts of Appeal include *Chesapeake Outdoor Enter., Inc. v. Commissioner*, 4th Cir. No. 98-2627 (in circuit mediation program); *Gaudiano v. Commissioner*, 6th Cir. No. 99-1294 (argued December 17, 1999); *Friedman v. Commissioner*, 6th Cir. No. 99-2378 (argued December 17, 1999); *Pugh v. Commissioner*, 11th Cir. No. 99-12646 (awaiting opinion). Many more cases are pending in the Tax Court, in district courts, and at various administrative levels within the Internal Revenue Service.

resolve the conflict among the circuits and to assure uniformity of treatment, consistent with the proper application of the federal tax laws.

II. The Decision Of The Court Of Appeals Is Erroneous.

The Court of Appeals erred in offsetting previously suspended losses against excluded COD income. The Court did correctly find that Taxpayers were entitled to an increase in basis as a result of the discharge, however. In light of the fact that some courts have disputed the latter finding, we briefly explain below why Taxpayers were entitled to an increase in basis. We then demonstrate that Taxpayers were likewise entitled to deduct previously suspended losses notwithstanding the corporation's realization of excluded COD income.

A. Discharge Of Indebtedness Income Realized By An S Corporation And Excluded From Income Under 26 U.S.C. § 108 Is An Item Of Income That Increases Shareholder Basis Under 26 U.S.C. §§ 1366 and 1367.

Subchapter S of the Code (26 U.S.C. §1361 *et seq.*) allows shareholders of qualified corporations to elect a "pass through" system of taxation under which corporate income, losses, deductions, and credits are directly attributed to the shareholders. *Bufferd v. Commissioner*, 506 U.S. 523, 525 (1993). Income, expenses, and other tax related items of an S corporation are passed through to its individual shareholders. § 1366. If an item of income (taxable or nontaxable) is taken into account under section 1366, the shareholder's basis in the stock of the S corporation is increased by that amount. § 1367(a).

Section 61(a)(12) provides that gross income includes COD income. Section 108(a)(1)(A) provides an exclusion of such

income in a case under Chapter 11 of the Bankruptcy Code. In the case of an S corporation, the determination of the amount of the exclusion (pursuant to section 108(a)) is made at the corporate level. § 108(d)(7)(A).

While COD income is excluded from gross income under section 108(a), there is a price for the exclusion in some, but not all, cases. To the extent that a bankrupt or insolvent taxpayer has what are referred to as "tax attributes" as part of his or her tax profile,[3] section 108(b)(1) provides that "the amount [of COD income] excluded from gross income . . . shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." The attributes potentially subject to reduction under section 108(b) include net operating losses ("NOLs"), capital loss carryforwards, and basis in property. *See* §§ 108(b)(2)(A)-(G). In the case of S corporations, which do not have NOLs, there is a special rule which requires that individual shareholder losses, suspended because of insufficient shareholder basis under section 1366(d)(1), are to be treated as NOLs for attribute reduction purposes. § 108(d)(7)(B).

It is not difficult to determine whether excluded COD income realized by the corporation constitutes an "item of income," subject to pass through for purposes of determining stock basis under sections 1366 and 1367. This question is easily resolved by the statutes themselves. All three Courts of Appeals and the District Court of Oregon concluded that excluded COD income of an S corporation is an "item of income" within the meaning of section 1366. *See Farley*, 202 F.3d at 206; *Gitlitz*, 182 F.3d at 1148; *Witzel*, 200 F.3d at 498; *Hogue*, 2000 WL 2651 at *2 . As the Tenth Circuit explained:

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[3] "Tax attributes" are characteristics derived from a taxpayer's tax history which may affect the taxpayer's tax liability in a given year.

> The Commissioner's protestations notwithstanding, we discern no intent by Congress to treat certain subchapter S corporation income at the corporate level while treating other income at the shareholder level. Such a scheme would fundamentally alter the manner in which subchapter S corporations are taxed. Section 1366(a)(1) makes clear that all items of income are attributed initially to the corporation. Because the subchapter S corporation is not a tax-paying entity, however, the items must pass through to shareholders unless they are absorbed by tax attribute reductions.

Gitlitz, 182 F.3d at 1148.

The benefit claimed by the Taxpayers in this case, -- an increase to shareholder basis that permits the current deduction of formerly suspended losses--was thus expressly allowed by the language of the statutes.

B. The Court of Appeals' Holding That Discharge Of Indebtedness Income Is Offset Against Any Existing Suspended Losses Is Contrary To The Plain Language Of The Statutes, Which Requires That Attribute Reduction Occur Following The Year Of Discharge.

The Court of Appeals went so far as to agree that the basis of Taxpayer's stock was increased by the amount of COD income. *Witzel*, 200 F.3d at 498 The Court, however, refused to allow the deduction of the suspended losses, stating that "section 108(d)(7)(A) requires that COD income of a subchapter S corporation be offset against any *existing* suspended losses arising from the operation of the corporation." *Witzel*, 200 F.3d at 498, (App. 6a). Unfortunately, the Court failed to consider section 108(b)(4)(A), which provides that attributes are reduced "after the determination of the tax

imposed by this chapter for the taxable year of the discharge." Indeed, in order to reach its result, the Court had to take a position squarely at odds with the statutory rules governing the timing of attribute reduction.

The Tenth Circuit in *Gitlitz* considered the timing issue a close question and acknowledged that, if corporate attributes were reduced after the taxable year of the discharge, "the taxpayers' theory must prevail." 182 F.3d at 1148. Although the Seventh Circuit did not offer any explicit reasoning as to the timing issue, the Court had to assume that attribute reduction occurs during, rather than after, the taxable year of discharge, and prior to the required pass through of all items of S corporation income. Unfortunately, the Seventh Circuit disregarded:

(1) The plain language of the statute, which requires that attribute reduction "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." § 108(b)(4)(A);

(2) Section 1017 of the Code, which expressly requires that property basis, one of the attributes subject to reduction, be reduced after the year of discharge; and

(3) The rules of sections 108(d)(7)(B) and 1366(d)(1), which require that all items of S corporation income for the year be taken into account at the shareholder level before the amount of the "suspended loss" attribute can be determined.

1. The Decision Of The Court of Appeals Conflicts With The Plain Language Of 26 U.S.C. § 108(b)(4)(A).

As noted above, section 108(b)(4)(A) provides that the tax attribute reduction required by section 108(b)(1) "shall be made after the determination of the tax imposed . . . for the taxable year of the discharge." This means that any tax attributes may be used in determining the tax for the taxable year of the discharge. It is only those attributes, if any, remaining after the tax computation that are subject to reduction. § 108(b)(4)(A).

Congress understood that attribute reduction was to be postponed until after the full computation of the current year's tax liability. Consistent with the plain meaning of the statutes, the Senate Report explains that section 108(b) provides that both the current year's loss and any NOL carryover to that year are potentially subject to reduction by excluded COD income, but added that "[t]hese reductions are made ***after*** the computation of the current year's tax." S. Rep. No. 96-1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 626 n.14 (emphasis added).

The Third Circuit in *Farley* noted that the *Gitlitz* court had concluded that the timing rule of section 108(b)(4)(A) was dispositive of the case. The *Farley* court agreed. 202 F.3d. at 205 fn. 4. However, the Third Circuit saw no statutory support for the Tenth Circuit's conclusion that section 108(b)(4)(A) was limited in its application to the computation of certain tax applications, such as limitations on deductions, charitable contribution limits, and alternative minimum tax, and did not require the determination of the taxpayer's ultimate tax liability before attributes were reduced. *Farley*, 202 F.3d. at 205.

Petitioners submit that section 108(b)(4)(A) cannot be interpreted to require that certain initial computations for the

calculation of tax liability for the year be made by taking tax attributes into account, while excluding those attributes in the final computation. The statute provides no hint that such a result is intended, nor any principled way of differentiating those computations that include tax attributes from those that do not.

The *Farley* court held that the plain language of the statute mandated the following result:

> The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year ***following*** the year of discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward. . . . Discharge of indebtedness income excluded from gross income under section 108(a)(1)(B) then passes through to the S corporation's shareholders pursuant to section 1366(a)(1)(A). Upon passing through to the S corporation shareholders, the discharge of indebtedness income causes an upward adjustment in the basis of the shareholder's S corporation stock pursuant to section 1367(a)(1)(A), thus allowing deductions for losses previously suspended because the corporation's stock lacked adequate basis. Finally the tax attribute reduction required by section 108(b) takes place on the first day of the tax year following the year of the discharge of indebtedness, as mandated by section 108(b)(4)(A).
>
> We hold that because the controlling statutes clearly provide that tax attribute reduction takes place after income has passed through the S corporation to its shareholders (pass through being a necessary prerequisite to "determin[ing] the tax imposed by this

> chapter for the taxable year of the discharge"), in the case of an insolvent S corporation, discharge of indebtedness income that is excluded from gross income by section 108(a), passes through to the shareholders, increases the shareholder's basis in their S corporation stock, thus allowing the shareholders to take deductions for S corporation losses suspended under section 1366(d)(1).

Farley, 202 F.3d 205-06 (emphasis added). Although the Seventh Circuit in *Witzel* held that section 108 attribute reduction eliminated the suspended losses, it failed to analyze, or even acknowledge the existence of, the section 108(b)(4)(A) timing rule.

Other courts that have considered this issue have uniformly held that attribute reduction is not made until after the tax liability for the year is computed. For example, in *CSI Hydrostatic Testers, Inc. and Subs. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam, adopting the opinion of the Tax Court*, 62 F.3d 136 (5th Cir. 1995), the Tax Court (and the Fifth Circuit by adoption) considered the application of the attribute reduction rules in the consolidated return setting, and held that tax attribute reduction under section 108(b)(4) does not occur "until the next taxable year." 103 T.C. at 414-415.

The Court of Appeals' opinion is also contrary to the Tax Court's holding in *Kahle v. Commissioner*, T.C.M. (RIA) 97,091. In *Kahle*, when considering the case of a bankruptcy estate which had come into possession of an individual taxpayer's tax attributes under section 1398, Judge Tannenwald held that, under section 108(b)(4), the taxpayer/bankrupt estate "may use the tax attributes to determine its tax liability for the year of discharge, after which the tax attributes are reduced by the estate under section 108(b)(2) before being returned to the debtor taxpayer."

The sole authority relied upon by the Tenth Circuit in *Gitlitz* is a treatise: C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice § 1398 (which coordinates the transfer of tax attributes between individual taxpayers in Chapter 11 and their bankruptcy estates). *See* 182 F.3d at 1149. Not only is the Court's approach contrary to the conclusion reached by the authors of the more highly regarded *Collier on Bankruptcy Taxation* (*see* 15 Collier On Bankruptcy ¶ 6.03[4][b][i], at 6-103 (Lawrence P. King ed., 15th ed. 1999)), but it is contrary to the conclusions of other respected commentators to consider the issue.[4]

2. The Court Of Appeals' Decision Renders The Code Internally Inconsistent, Placing The Timing Rules For Attribute Reduction Under 26 U.S.C. § 108(b)(4)(A) In Conflict With The Timing Rules For Attribute Reduction Under 26 U.S.C. § 1017.

Section 1017 is another part of the insolvency taxation regime, and it governs the treatment of one of the tax attributes listed in section 108(b)(2): basis in assets. Section 1017(a) specifically provides that, if the taxpayer has COD income and section 108(b)(2)(E) requires a reduction in the taxpayer's basis in property as part of the attribute reduction process, then the amount of COD income applied against basis "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in

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[4] A representative sampling of the overwhelming majority of commentators who have reached this conclusion includes Witt, "Report of the [ABA] Section 108 Real Estate and Partnership Task Force," 46 Tax Law. 209, 234 (1992); Hebenstreit, "Tying Together the Tax and Bankruptcy Codes," 54 Ohio St. L. 859, 889 n. 21 (1993); and Tax Management Portfolio 731: S Corporation Operations, § III.B.1.a at note 414.2 (1999).

which the discharge occurs." Thus, under section 1017, where the taxpayer sells an asset with a $100 basis in the year of discharge for $100 and has $100 COD income, the asset basis will not be reduced by the COD income in determining the taxpayer's gain and tax liability for the year of the discharge. However, if the taxpayer instead sold the asset in the year after the discharge, his basis would be lower, producing gain recognition and tax liability in that year.[5]

Section 1017 was amended as part of the Bankruptcy Tax Act of 1980 (94 Stat. 3389), as was section 108. Prior to amendment in 1980, section 108 provided a much more limited exclusion for COD income, specifically conditioned upon the taxpayer's affirmative election to reduce his basis in accordance with section 1017. *See* 26 U.S.C. § 108 (1979), amended by 94 Stat. 3389 (1980). The pre-1980 version of section 1017 provided that where COD income was excluded under section 108, the taxpayer's basis in property owned at the beginning of

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[5] Section 108(b)(5) allows taxpayers to elect to have reduction in asset basis under sections 108(b)(2)(E) and 1017 occur in lieu of other attribute reduction. Under section 1017, such reduction takes place the first day of the following year. The Court of Appeals' reasoning, which must require attribute reduction in the year of discharge, offsetting the basis increase for COD income, would allow taxpayers with both basis in assets and suspended losses to elect, under section 108(b)(5), to have some or all of the attribute reduction (basis reduction) occur in a different year from the year of the sections 1366 and 1367 pass through. This would mean that, where taxpayers made the section 108(b)(5) election, excluded COD income would be added to stock basis in the year of the discharge and would not be "absorbed" in the attribute reduction process, because attribute reduction with respect to basis in property would not occur until the following year. Such electing taxpayers would be allowed to avoid a basis reduction and be permitted to make use of suspended losses during the year of the discharge, unlike their non-electing counterparts.

or at any time during the taxable year of the discharge would be reduced "as of the first day of the taxable year in which the discharge occurred." § 1017 (1979), amended by 94 Stat. 3389 (1980). The new sections 108 and 1017 provide additional relief to insolvent and bankrupt taxpayers. That is, section 108(b)(4)(A) permits such taxpayers who have COD income to determine their tax liability for the year of the discharge before making any attribute reduction. The timing rules of section 1017 were likewise amended so as to be consistent with new section 108(b)(4)(A), and to provide that, in the case of basis in assets, just as with all other attributes listed under section 108(b)(2), attribute reduction occurs after the year of discharge, i.e., at the beginning of the next succeeding taxable year.

The Court of Appeals' opinion artificially and inappropriately frustrates Congress's intention and bifurcates attribute reduction into two separate years: the year of the discharge for some attributes and the following year for basis in property. This is a perverse and indefensible result, and is belied by the plain meaning of the statutes.

C. The Court of Appeals' Decision Conflicts With The Standards Of Statutory Interpretation Established By This Court.

The real reason that the Court of Appeals and the Tax Court held for the Commissioner below was not that the statutory language compelled the position advanced by the Commissioner, but rather because the courts apparently believed that the Taxpayers' position would result in a "windfall." This perception is unfounded.[6] The Taxpayers

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[6] The Third Circuit noted the government had presented scant evidence that following the statutory language would provide the taxpayers with benefits not intended. *Farley*, 202 F.3d at 206.

merely seek equal treatment with other similarly situated taxpayers. Suspended losses are governed by the same timing rules applicable to all other tax attributes, and should be available to reduce tax liability in the year of the discharge. The language of section 108(b)(4)(A) applies equally to all attributes; there is no way to parse its language to provide for the reduction of certain disfavored attributes in the year of the discharge, but other more favored attributes in the subsequent year.

The Court of Appeals treats excluded COD income to the extent of the suspended losses just as if it were fully taxable income, and not subject to an exclusion under section 108. If the COD income had been taxable income, Taxpayers would have increased their basis by the amount of the COD income. The suspended losses would then have been freed up, offsetting the taxable income and reducing the Taxpayer's basis under section 1367(a)(2)(B). This is exactly the position in which the Court of Appeals places Taxpayers, who were supposed to receive the benefit of an exclusion from tax. To avoid a perceived "windfall," the Seventh Circuit has unfairly denied a substantial portion of the benefit flowing from the section 108(a) exclusion. The Court treats the excluded COD income, to the extent of suspended losses, as though it were taxable income. This is directly contrary to Congress' language and intent.

The Court of Appeals' cure is worse than the disease. The federal courts do not have the authority to revise and distort the Code in order to reach what the Commissioner portrays as

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Moreover, the *Farley* court reasoned that in cases where an S corporation had basis in property in excess of encumbrances on that property equal to or greater than the amount of the discharge, there would not be even the possibility of an unwarranted benefit. *Id.* at 208.

"better" tax policy. *See Abdalla v. Commissioner*, 647 F.2d 487, 503 (5th Cir. 1981); *International Trading Company v. Commissioner*, 484 F.2d 707, 711 (7th Cir. 1973). In *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 841 (5th Cir. 1992), the court clearly articulated this Court's longstanding requirement that courts construe the Code as written:

> Indeed, the Supreme Court stated in [*Hanover Bank v. Commissioner*, 369 U.S. 672 (1962)] that 'we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of a statute.' 369 U.S. at 387, 82 S.Ct. at 1089. Similarly, the Court has explained that 'where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall.' *Lewyt Corp. v. Commissioner of Internal Revenue*, 349 U.S. 237, 240, 75 S.Ct. 736, 739, 99 L.Ed. 1029 (1955). Therefore, although we should try to avoid double tax benefits, courts must leave them standing if the Code positively requires this outcome.

Nothing in the language of the statutes relating to the pass through of income and the calculation of basis or the statute relating to the exclusion of COD income even remotely suggests that taxpayers cannot increase their stock basis by COD income, and then deduct losses prior to engaging in attribute reduction.

The Nation's tax law should not be a moving target, requiring taxpayers to overcome an endless succession of arguments based upon what the Commissioner or the courts believe would make good tax policy. Rather, courts are

required to base their interpretation of the Internal Revenue Code upon the language of the statutes as enacted. Perhaps more important for the Court's consideration of this Petition, the meaning of the Internal Revenue Code cannot change depending on the circuit of residence of the taxpayer. The Code reflects important national policies and weighty legislative decisions. It must be applied uniformly. The Court should grant this Petition and resolve the split of authority in the lower courts.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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APRIL 2000

APPENDIX

In the
United States Court of Appeals
For the Seventh Circuit

No. 99-2482

WILLIAM C. WITZEL and GENE E. WITZEL,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court
No. 6592-97—**Juan F. Vasquez**, *Judge.*

ARGUED DECEMBER 9, 1999—DECIDED JANUARY 18, 2000

Before POSNER, *Chief Judge*, and COFFEY and MANION, *Circuit Judges.*

POSNER, *Chief Judge.* This is an appeal by taxpayers from a decision by the Tax Court (77 T.C.M. (CCH) 1487 (1999)) holding, consistently with *Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999), and *Nelson v. Commissioner*, 110 T.C. 114 (1998), that "discharge of indebtedness" (equivalently, "cancellation of debt") income that is excluded from gross income under 26 U.S.C. § 108(a) does not pass through to a shareholder of a subchapter S corporation and therefore does not increase the shareholder's basis.

A debt that is cancelled is income to the debtor, since he has been enriched by the amount of the debt. § 61(a)(12); see also *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). But when, as in the present case, the debtor is in bankruptcy under Chapter 11 of the Bankruptcy Code, section 108(a) of the Internal Revenue Code exempts the debtor's cancellation-of-debt (COD) income from federal income tax. Mr. Witzel is the sole shareholder of a subchapter S corporation that as part of its discharge from Chapter 11 was permitted to cancel some $5.4 million in debts. Income received by a subchapter S corporation is taxed to each shareholder pro rata as if he had received the income directly, 26 U.S.C. § 1366, but by virtue of section 108(a) Witzel incurred no liability to pay tax on any of the $5.4 million in additional cancellation of debt income.

So far, so good; but at the time of his discharge from bankruptcy, Witzel had loss carryforwards arising from the operation of the subchapter S corporation that he would have liked to offset against his other, taxable income but could not because the basis of his S corporation stock was too low (was in fact zero). These are called "suspended losses," because their use as a tax deduction is suspended until the corporation generates income that can be offset against them. § 1366(d). As Witzel points out, the income of a subchapter S corporation is added to the basis of the shareholder's stock (or pro rata to the basis of each shareholder's stock if there is more than one shareholder) and then subtracted when the income is distributed to the shareholder. § 1367. If it were not subtracted, the shareholder might have to pay capital-gains tax on the amount of the distribution if he sold his stock, and that would be the kind of double taxation that the Internal Revenue Code allows shareholders in a subchapter S corporation to escape.

What Witzel wanted to do in this case, and the Tax Court forbade, was to use his corporation's $5.4 million

of tax-exempt COD income to increase the basis in his stock by that amount and by doing so offset a portion of his loss carryforwards (which at the time totaled almost $3 million) against his current income and so reduce the tax on that income. This would be a kind of double dipping. Witzel received a tax break on the $5.4 million; it is not taxable income to him. He wants to get another tax break by using that amount to reduce his other, taxable income by a portion of his suspended losses that, were it not for his $5.4 million in tax-free income, he could not use to obtain a tax benefit, at least not yet. He wishes to parlay a $5.4 million tax exemption into a more than $8 million tax exemption.

It is hard to understand the rationale for using a tax exemption to avoid taxation not only on the income covered by the taxation but also on unrelated income that is not tax exempt. The Witzels' lawyer admitted at argument that his clients are seeking a windfall. See also James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations* ¶ 14.04[2], pp. 14-10 to 14-11 (3d ed. 1993). But of course not all tax statutes have a public-interest rationale, many being the product of favoritism and interest-group pressures. So we must attend to the statute.

In excluding COD income from gross income, the Code requires, among other things, that the taxpayer's net operating losses be reduced by the amount of the excluded income. § 108(b)(2)(A). In the case of subchapter S corporations, this provision "shall be applied at the corporate level." § 108(d)(7)(A). Because suspended losses are deemed "net operating losses," § 108(d)(7)(B), the government argues that they must be reduced by the amount of tax-exempt COD income and so they are unavailable to offset against Witzel's other income. He argues that the suspended losses, like other gains and losses of subchapter S corporations, passed through the corporation to him and so there is nothing "at the corporate level" to offset against the corporation's tax-exempt income, which also

passes through to him and is thus available to offset his suspended losses. The government argues, to the contrary, that "at the corporate level" means that the suspended losses and COD income stick there.

The government's interpretation is not inevitable. Application of section 108 "at the corporate level" could mean just that the relevant bankruptcy status which triggers a tax exemption for COD income is that of the corporation, not the shareholder. But this would leave out of account the reference in subsection (d) (the "at the corporate level" subsection) to subsection (b), the subsection that reduces tax "attributes" (here, the suspended losses) by the amount of the excluded income. If (b) is to be applied at the corporate level, the implication, as the government argues, is that the excluded income must be set off against the suspended losses and the latter reduced accordingly. The argument is not conclusive; the interpretive question could be resolved either way; but in these circumstances of dubiety the sensible result—denying the taxpayers the double windfall—seems to us the preferable one.

We are unpersuaded, however, by the government's further argument, which the Tenth Circuit accepted in *Gitlitz* and which the Tax Court accepted not only in *Gitlitz* but also in *Nelson* and the present case, that COD income does not increase the basis of the shareholder's stock in the subchapter S corporation. 182 F.3d at 1149-51. (For criticism, see Stephen R. Looney, "S Corp. Prop. Regs.—No Surprises, But Two Potentially Controversial Provisions," 90 *J. Taxation* 69, 72 (1999).) In effect, the government wants the courts to do for subchapter S corporations by interpretation what the Internal Revenue Code does explicitly in the case of partnerships—simultaneously with increasing the partner's basis by his share of the partnership's COD income decrease the partner's basis by the same amount because "any decrease in a partner's share of the liabilities of a partnership . . . shall

be considered as a distribution of money to the partner by the partnership." 26 U.S.C. § 752(b); see S. Rep. No. 1035, 96th Cong., 2d Sess. 21-22 (1980); Looney, *supra*, at 72.

Recall that section 1367 of the Internal Revenue Code increases the basis of the shareholder's stock in the subchapter S corporation by the amount of corporate income passed through to him. Section 1366 is explicit that the pass through includes tax-exempt income. § 1366(a)(1)(A). The Tax Court believes that COD income is not really tax exempt, because, as we know from section 108(b)(2)(A), such income reduces suspended losses by a dollar for every dollar of COD income and thus operates to defer rather than to eliminate tax. (The tax is paid when the suspended losses, having been reduced, are not available to offset taxable income in the future.) The Supreme Court said the same thing in passing in *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 580 (1991), but, with all due respect, the Court's observation is not accurate. To the extent that the recipient of COD income (Witzel, to whom the income passed through his subchapter S corporation) never accrues suspended losses which that income reduces (thus reducing the tax benefits that they generate), his COD income will be tax exempt in the fullest sense; it will not generate tax liability even indirectly. More important, section 1366 is not limited to tax-exempt income, so if COD income is not "really" tax exempt this would not take it out of the section.

We think, therefore, that while Witzel was rightly forbidden to deduct his existing suspended losses, because they were offset at the corporate level by the amount of his corporation's COD income, the basis in his stock was increased by that income, and this may enable him someday to deduct *future* suspended losses. We offer this view tentatively, in part because the Tenth Circuit has held the contrary and we are reluctant to precipitate an intercircuit

conflict, in part because Mr. Witzel may never again have suspended losses, making the issue rather moot as to him unless he someday sells his stock and his capital-gains tax liability is affected by his basis (higher in our view than in the Tax Court's), and in part because a recently promulgated Treasury Regulation (not applicable to this case, however, because it applies only to tax years beginning on or after August 18, 1998) adopts the Tax Court's interpretation of section 1366 that we are criticizing. Treas. Reg. § 1.1366-1(a)(2)(viii), 64 Fed. Reg. 71641 (Dec. 22, 1999). The validity of the regulation is for the future; it is enough to rule today that section 108(d)(7)(A) requires that COD income of a subchapter S corporation be offset against any *existing* suspended losses arising from the operation of the corporation.

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATE TAX COURT
Washington, D.C. 20217

WILLIAM C. WITZEL AND GENE E. WITZEL, Petitioners,	)	
v.	)	Docket No. 6592-97
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed March 4, 1999, it is

ORDERED and DECIDED that there is a deficiency in income tax due from petitioners for the taxable year 1993 in the amount of $602,119.

Signed Juan F. Vasquez
Juan F. Vasquez
Judge

Entered: March 4, 1999

UNITED STATE TAX COURT
Washington, D.C. 20217

WILLIAM C. WITZEL AND GENE E. WITZEL, Petitioners,	)	
v.	)	Docket No. 6592-97
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

T.C. Memo. 1999-64

UNITED STATES TAX COURT

WILLIAM C. WITZEL AND GENE E. WITZEL, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6592-97. Filed March 4, 1999

Wayne A. Cooper, for petitioners

John O. Walsh, for respondent.

MEMORANDUM OPINION

VASQUEZ, Judge: Respondent determined a deficiency of $602,119 in petitioners' 1993 Federal income tax.

After concessions,[1] the sole issue for decision is whether discharge of indebtedness (COD) income excluded under section 108(a) from the gross income of an S corporation passes through to the shareholder of the S corporation as an item of income under section 1366(a)(1)(A) and consequently increases the basis of the shareholder's stock in the S corporation under section 1367.[2]

The parties submitted this case fully stipulated. Rule 122. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference. At the time they filed the petition, petitioners resided in Sandwich, Illinois.

Background

At all relevant times, petitioner[3] was the sole shareholder of Water Products Co. of Illinois, Inc. (Water Products), an S corporation. In 1991, Water Products declared bankruptcy under chapter 11 of the Bankruptcy Code.

In 1992, Water Products realized COD income under section 61(a)(12) in the amount of $5,404,323. As a result of its bankruptcy, Water Products excluded the COD income from its gross income.

In 1992, petitioner had suspended losses (under section

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[1] Petitioners concede that respondent's adjustments to their itemized deductions, deduction for exemptions, and alternative minimum tax are correct if the Court concludes petitioners are not entitled to increase the basis in their S corporation stock.

[2] All section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[3] References to "petitioner" are to William C. Witzel.

1366(d)) from Water Products in the amount of $2,964,481 and a zero basis in his Water Products stock before considering the effect of the excluded COD income.

For 1993, petitioners filed a joint Federal income tax return. On the return, petitioners increased the basis in the Water Products stock by the amount of the excluded COD income ($5,404,323). As a result of the increased basis, in 1993, petitioners deducted suspended losses of $2,549,251.

Discussion

Petitioners argue that they were entitled to increase their basis in Water Products stock by their share of the excluded COD income. In Nelson v. Commissioner, 110 T.C. 114 (1998), we held that COD income excluded by section 108(a) did not pass through to an S corporation shareholder under section 1366(a)(1)(A); therefore, the S corporation shareholder could not increase his basis in the stock under section 1367(a)(1).

Petitioners do not distinguish this case from Nelson. Petitioners, however, contend that in Nelson we failed to consider the following legal issues: (1) The reduction of tax attributes dictated by section 108(b) is an alternative to taxation and does not mean that excluded COD income is not tax exempt, (2) Congress' intent to treat all shareholders in S corporations similarly under section 108(d)(7), and (3) the dissimilarity in treatment between section 103 (exclusion of State bond interest from gross income) and section 108. We disagree with petitioners. In Nelson, we addressed all of these arguments in detail. Nelson v. Commissioner, supra at 122-125.

We shall follow our recent Court- reviewed opinion. We therefore conclude that petitioners may not increase their basis

in the stock by the amount of the excluded COD income.

To reflect the foregoing,

Decision will be entered for respondent.

UNITED STATES TAX COURT

WILLIAM C. WITZEL and GENE E. WITZEL,	)	
	)	Docket No. 6592-97
Petitioners,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto may be accepted as authentic and are incorporated in this stipulation and made a part hereof.

1. Petitioners, William C. Witzel and Gene E. Witzel, were residents of Sandwich, Illinois at the time the petition was filed in this case.

2. Petitioners filed a joint federal income tax return for the taxable year 1993. Attached hereto as Joint Exhibit 1-A is a copy of petitioners' joint federal income tax return for the taxable year 1993.

3. On January 6, 1997, respondent issued a notice of deficiency to petitioners for the taxable year 1993. Attached hereto as Joint Exhibit 2-B is a copy of the notice of deficiency issued to the petitioners for the taxable year 1993.

4. At all relevant times, petitioner William C. Witzel was the sole shareholder of Water Products Company of Illinois, Inc.

5. At all relevant times, Water Products Company of Illinois, Inc. was an S corporation.

6. In 1991, a petition for bankruptcy was filed on behalf of Water Products Company of Illinois, Inc. under Chapter 11 of the Bankruptcy Code.

7. The bankruptcy case for Water Products Company of Illinois, Inc. was administered by the United States Bankruptcy Court for the Northern District of Illinois.

8. On January 31, 1992, a Debtor's Plan of Reorganization Dated January 31, 1992, was filed on behalf of Water Products Company of Illinois, Inc. with the Bankruptcy Court.

9. On April 8, 1992, a Debtor's First Amendment to Plan of Reorganization Dated January 31, 1992, was filed on behalf of Water Products Company of Illinois, Inc. with the Bankruptcy Court.

10. On April 28, 1992, the Bankruptcy Court entered an Order Confirming Plan. Attached hereto as Joint Exhibit 3-C is a copy of the Order Confirming Plan, including the Debtor's Plan which is attached hereto.

11. In 1992, Water Products Company of Illinois, Inc. realized discharge of indebtedness (cancellation of debt) income, under the provisions I.R.C. § 61(a)(12), in the amount of $5,404,323.00 as a result of the bankruptcy.

12. Water Products Company of Illinois, Inc.

excluded from its gross income the entire amount of the indebtedness discharged. Attached hereto as Joint Exhibit 4-D is a copy of the Form 1120S U.S. Income Tax Return of an S Corporation for Water Products Company of Illinois, Inc. for its taxable year ended November 30, 1992.

13. On line 8 of the Form 982 attached to the Form 1120S U.S. Income Tax Return of an S Corporation for Water Products Company of Illinois, Inc. for its taxable year ended November 30, 1992, Water Products Company of Illinois, Inc. reported the amount of $1,089,705.00 as an amount excluded from gross income "[a]pplied to reduce the basis of nondepreciable and depreciable property if not reduced on line 4." Water Products Company of Illinois, Inc. did not report any amounts on lines 4, 6, 7, 9, 10, 11, and 12 of the Form 982. Respondent does not contest the amount reported on line 8. In addition, respondent does not contend that any amounts should have been reported on lines 4, 6, 7, 9, 10, 11, and 12 of the Form 982.

14. Petitioner William C. Witzel had a suspended loss (loss in excess of his basis in stock) from Water Products Company of Illinois, Inc. for the taxable year 1990 in the amount of $899,478.00.

15. Petitioner William C. Witzel had a suspended loss from Water Products Company of Illinois, Inc. for the taxable year 1991 in the amount of $2,008,568.00.

16. Petitioner William C. Witzel had a suspended loss from Water Products Company of Illinois, Inc. for the taxable year 1992 in the amount of $56,435.00.

17. Petitioner William C. Witzel did not have any other suspended losses from Water Products Company of Illinois, Inc.

18. The basis of petitioner William C. Witzel's stock in Water Products Company of Illinois, Inc. for the taxable year 1992 was zero, unless petitioner William C. Witzel was entitled to increase the basis of his stock in Water Products Company of Illinois, Inc. on account of the cancellation of debt (COD) income excluded from the gross income of Water Products Company of Illinois, Inc.

19. Petitioners contend that in 1992 petitioner William C. Witzel was entitled to increase the basis of his stock in Water Products Company of Illinois, Inc. by the amount of $5,404,323.00 on account of the COD income excluded from the gross income of Water Products Company of Illinois, Inc.

20. Respondent contends that petitioner William C. Witzel was not entitled to increase the basis of his stock in Water Products Company of Illinois, Inc. on account of the COD income excluded from the gross income of Water Products Company of Illinois, Inc.

21. The parties agree that if petitioners were entitled to deduct the suspended losses from Water Products Company of Illinois, Inc. for the taxable years 1990, 1991 and 1992 in the amounts of $899,478.00, $2,008,568.00 and $56,435.00, respectively, in the calculation of their income tax liability for the taxable year 1992, then petitioners were entitled to a net operating loss carryover deduction from the taxable year 1992 to the taxable year 1993 in the amount of $2,549,251.00, as claimed on their return for the taxable year 1993.

22. The parties agree that if petitioners were not entitled to deduct the suspended losses from Water Products Company of Illinois, Inc. for the taxable years 1990, 1991 and 1992 in the amounts of $899,478.00, $2,008,568.00 and $56,435.00, respectively, in the calculation of their income tax liability for the taxable year 1992, then petitioners were not

entitled to any net operating loss carryover deduction from the taxable year 1992 to the taxable year 1993.

23. The parties agree that respondent's adjustments with respect to itemized deductions, the standard deduction, and the deduction for exemptions are computational adjustments based on adjusted gross income and will be resolved automatically as a result of the Court's decision concerning the effect of COD income of Water Products Company of Illinois, Inc. on the basis of petitioner William C. Witzel's stock in Water Products Company of Illinois, Inc. The alternative minimum tax adjustment will also be resolved automatically as a result of the Court's decision on the same issue.

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Date: June 12, 1998

UNITED STATES TAX COURT

WILLIAM C. WITZEL and GENE E. WITZEL	)	Docket No. 6592-97
Petitioners	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE	)	
Respondent	)	

PETITION

The Petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in the Commissioner's notice of deficiency (Letter 894 (RO) (Rev. 04/93), Symbols ED:CV:8000 CHI) dated January 6, 1997, and as the basis for the Petitioner's case allege as follows:

1. The Petitioners are individuals with mailing address now at Post Office Box 50, Aurora, Illinois 60507-0050 and legal residence now at 15700 Pratt Road, Sandwich, Illinois 60548. Petitioner William C. Witzel's taxpayer identification number is 358-34-6197 and Petitioner Gene C. Witzel's taxpayer identification number is 335-36-9063. The returns for the period here involved was filed with the Office of the Internal Revenue Service at Kansas City, Missouri.

2. The Notice of Deficiency (a copy of which, including so much of the statement and schedules accompanying the notice as is material, is attached and marked Exhibit A) was

mailed to Petitioners on January 6, 1997, and was issued by the Office of the Internal Revenue Service at Chicago, Illinois.

3. The deficiency as determined by the Commissioner is in income tax for the calendar year 1993 in the amount of $602,119.00, of which the entire amount is in dispute.

4. The determination of the tax set forth in said Notice of Deficiency is based upon the following errors:

a. The Commissioner erred in determining that Petitioners are not entitled to a net operating loss carryover from the taxable year ended December 31, 1992, in the amount of $2,549,251.00.

b. The Commissioner erred in determining that Petitioners' taxable income for the taxable year ended December 31, 1993 should be increased by $25,511.00 due to a decrease in the amount of allowable itemized deductions as a result of the Commissioner's determination in 4.a. above which increases taxpayer's adjusted gross income.

c. The Commissioner erred in determining that Petitioners' taxable income for the taxable year ended December 31, 1993 should be increased by $4,700.00 due to a decrease in the amount of the allowable deduction for exemptions as a result of the Commissioner's determination in 4.a. above.

5. The facts upon which Petitioners rely, as the basis of the Petitioners' case, are as follows:

a. Petitioners are husband and wife.

b. Petitioners filed a joint income tax return for the tax year ended December 31, 1993.

c. Petitioners correctly reported their taxable income in the taxable year ended December 31, 1993.

d. Petitioner William Witzel was the 100% shareholder in an Illinois corporation known as Water Products Company of Illinois, Inc.

e. At all times relevant hereto, Water Products Company of Illinois, Inc. had elected to be taxed as an S corporation under Subchapter S of the Internal Revenue Code.

f. On May 4, 1992, the order confirming the Plan of Water Products Company of Illinois, Inc. was entered in the docket of the United States Bankruptcy Court for the Northern District of Illinois in proceedings for a reorganization under Chapter 11 of the United States Bankruptcy Code.

g. During the course of the bankruptcy, Water Products Company of Illinois, Inc. had income from discharge of indebtedness in the amount of $5,404,323.00.

h. Water Products Company of Illinois, Inc. properly excluded from taxable income such discharge of indebtedness income.

i. Petitioner William Witzel's basis in his stock in Water Products Company of Illinois, Inc. was increased as a result of the discharge of indebtedness income of Water Products Company of Illinois, Inc.

j. Due to the increase in Petitioner William Witzel's basis in his stock in Water Products Company of Illinois, Inc., previously suspended losses of $899,478.00, $2,008,568.00 and $56,435.00 from the tax years ended December 31, 1990, 1991 and 1992, respectively, became deductible for the year ended December 31, 1992.

k. Petitioners properly filed an Amended U.S. Individual Income tax return for calendar year 1992 claiming these suspended losses which resulted in a net operating loss of $2,817,841.00 of which of which $117,820.00 and $150,770.00 is carried back to calendar years 1989 and 1991, respectively, resulting in a net operating loss carryforward of $2,549,251.00 to calendar year 1993.

1. Petitioners are entitled to the net operating loss carryover from the taxable year ended December 31, 1992 in the taxable year ended December 31, 1993 in the amount of $2,549,251.00.

WHEREFORE, it is prayed that:

1. The Court hear this case and determine that there are no deficiencies for the taxable year ended December 31, 1993.

2. The Court grant such other relief as may be appropriate.

Dated: April 3, 1997

/s/ Wayne A. Cooper
Wayne A. Cooper
Tax Court Bar No. CW0373
Burke, Warren & MacKay, P.C.
330 N. Wabash Avenue
22nd Floor
Chicago, Illinois 60611
(312) 840-7000

INTERNAL REVENUE SERVICE
CERTIFIED MAIL
Date: January 6, 1997

DEPARTMENT OF THE TREASURY

Taxpayer Identification Number:
358-34-6197
Form Number:
1040

Tax Year Ended
December 31, 1993

Tax Deficiency
$602,119.00

Person to Contact:
Eulalia S. Davis
Contact Telephone Number:
(312) 886-5736
Extension #637

Mr. William C. Witzel and
Mrs. Gene E. Witzel
c/o Mr. Wayne A. Cooper
225 West Washington Street; 24th Floor
Chicago, Illinois 60606

and

Mr. William C. Witzel and
Mrs. Gene E. Witzel
c/o Mr. Stephen R. Meindl
Clifton, Gunderson & Company
1211 West 22nd Street; Suite 408
Oak Brook, Illinois 60521

and

Mr. William C. Witzel and
Mrs. Gene E. Witzel
Post Office Box 50
Aurora, Illinois 60507-0050

Dear Sir or Madam:

NOTICE OF DEFICIENCY

We determined that you owe an additional amount, as shown above. This letter is your NOTICE OF DEFICIENCY as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing

date of this letter (150 days if addressed to you outside the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. To get a petition form and the rules for filing a petition, write to: United States Tax Court, 400 Second Street, NW, Washington, D.C. 20217.

Send the completed petition form, a copy of this letter, and a copy of all statements and schedules you received with this letter to the Tax Court at the same address.

The time you have to file a petition with the court (90 or 150 days) is fixed by law. The court cannot consider your case if you file the petition late.

If this letter is addressed to both husband and wife, and both want to petition the Tax Court, BOTH must sign and file the petition or each must file a separate, signed petition. If only one of you petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse.

Small Tax Cases

The Tax Court has a simplified procedure for small tax cases, when the amount in dispute is $10,000.00 or less for any one tax year. You can get information about this procedure, as well as a petition form, by writing to the Clerk of the United States Tax Court at the court address shown in the second paragraph above. You should write promptly if you intend to file a petition with the court.

If you decide not to file a petition with the Tax Court, please sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience.

If you are a C corporation, under Internal Revenue Code Section 6621(c), large corporate underpayments may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the deficiency after 90 days from the mailing date (150 days if this letter is addressed to you outside the United States).

If you have any questions about this letter, you may call or write to the person whose name is shown above. If the telephone number is outside your local calling area, you will be charged for a long distance call. If you write, please attach a copy of this letter to help us identify your account. Also, include your daytime telephone number so we can call you if necessary.

Sincerely yours,

Margaret Milner Richardson
Commissioner of Internal Revenue
By
/s/ ASSOCIATE CHIEF

Enclosures:
Copy of this letter
Waiver - Form 4089
Statement
Envelope

26 U.S.C. § 108. Income from discharge of indebtedness

(a) Exclusion from gross income-

(1) In general.-- Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if--

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

(C) the indebtedness discharged is qualified farm indebtedness, or

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

(2) Coordination of exclusions.--

(A) Title 11 exclusion takes precedence.-- Subparagraphs (B), (C), and (D) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) Insolvency exclusion take precedence over qualified farm exclusion and qualified real property business exclusion.--Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(3) Insolvency exclusion limited to amount of insolvency.--In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

(b) Reduction of tax attributes.--

(1) In general.--The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction.--Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL.--Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit.--Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit.--The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers.--Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction.--

(i) In general.--The basis of the property of the taxpayer.

(ii) Cross reference.--

For provisions for making the reduction described in clause (i), see section 1017.

(F) Passive activity loss and credit carryovers.--Any passive activity loss or credit carryover of the taxpayer under section 469(b) form the taxable year of the discharge.

(G) Foreign tax credit carryovers.--Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction.--

(A) In general.--Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction.--The reductions described in subparagraphs (B), (C), and (G) shall be 33 1/3 cents for each dollar excluded by subsection (a).

(4) Ordering rules.--

(A) Reductions made after determination of tax for year.--The reductions described in paragraph (2) shall be

made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) Reductions under subparagraph (A) or (D) of paragraph (2).--The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years rom which each such carryover arose.

(C) Reductions under subparagraphs (B) and (G) of paragraph (2).--The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

(5) Election to apply reduction first against depreciable property.--

(A) In general.--The taxpayer may elect to apply any portion of the reduction referred to in paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

(B) Limitation.--The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(C) Other tax attributes not reduced.--Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

(c) Treatment of discharge of qualified real property business indebtedness.--

(1) Basis reduction.--

(A) In general.--The amount excluded from gross income under subparagraph (D) of subsection (a)(1) shall be applied to reduce the basis of the depreciable real property of the taxpayer.

(B) Cross reference.--

For provisions making the reduction

described in subparagraph (A), see section 1017.

(2) Limitations.--

(A) Indebtedness in excess of value.--The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of--

(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(B) Overall limitation.--The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

(3) Qualified real property business indebtedness.--The term "qualified real property business indebtedness" means indebtedness which--

(A) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property,

(B) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and

(c) with respect to which such taxpayer makes an election to have this paragraph apply.

Such terms shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being

refinanced.

(4) Qualified acquisition indebtedness.--For purposes of paragraph (3)(B), the term "qualified acquisition indebtedness" means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct reconstruct, or substantially improve such property

(5) Regulations.--The Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means.

(d) Meaning of terms; special rules relating to certain provisions

(1) Indebtedness of taxpayer.--For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness--

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case.--for purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent.--For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

[(4) Repealed. Pub.L. 99-514, Title VII, § 822(b)(3)(A), October 22, 1986, 100 Stat.2373]

(5) Depreciable property.--The term "depreciable property" has the same meaning as when used in section 1017.

(6) Certain provisions to be applied at partner level.--In the case of a partnership, subsections (a), (b), (c) and (g) shall be applied at the partner level.

(7) Special rules for S corporation.--

(A) Certain provisions to be applied at corporate level.--In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level

(B) Reduction in carryover of disallowed losses and deductions.-- In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

(C) Coordination with basis adjustments under section 1367(b)(2).--For purposes of subsection (e)(6), a shareholders's adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

(8) Reduction of tax attributes in title 11 cases of individuals to be made by estate.--In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraph (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

(9) Time for making election, etc.--

(A) Time.--An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

(B) Revocation only with consent.--An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

(C) Manner.--An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

(10) Cross reference.--

For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

(e) General rules for discharge of indebtedness (including discharges not in Title 11 cases or insolvency).--For purposes of this title--

(1) No other insolvency exception.--Except as otherwise provided in this section. there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

(2) Income not realized to extent of lost deductions.--No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

(3) Adjustments for unamortized premium and discount.--The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

(4) Acquisition of indebtedness by person related to debtor.

(A) Treated as acquisition by debtor.--For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

(B) Members of family.--For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual

consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

(C) Entities under common control treated as related.--For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

(5) Purchase-money debt reduction for solvent debtor treated as price reduction.--If--

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur--

(i) in a title 11 case, or

(ii) when the purchaser is insolvent and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

(6) Indebtedness contributed to capital.--Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital--

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

(7) Recapture of gain on subsequent sale of stock--

(A) In general.--If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245--

(i) such stock (and any other property the

basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor--

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange,

shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 345(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall br reduced by the amount (if any) included in the creditor's gross income on the exchange.

(B) Special rule for cash basis taxpayers.--In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

(C) Stock of parent corporation.--For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

(D) Treatment of successor corporation.--For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

(E) Partnership rule.--Under regulations

prescribed by the Secretary, rules similar to the rules of the foregoing subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

(8) Indebtedness satisfied by corporation's stock.--For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications.--Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

(10) Indebtedness satisfied by issuance of debt instrument.--

(A) In general.--For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

(B) Issue price.--For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

(f) Student loans.--

(1) In general.--In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be

discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

(2) Student loan.--For purposes of this subsection, the term "student loan" means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by--

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation--

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made--

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term "student loan" includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in

attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

(3) Exception for discharges on account of services performed for certain lenders.--Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge in on account of services performed for either such organization.

(g) Special rules for discharge of qualified farm indebtedness.--

(1) Discharge must be by qualified person.--

(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and

(B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

(3) Amount excluded cannot exceed sum of tax attributes and business and investment assets.--

(A) In general.--Subparagraph (C) of subsection (a)(1) shall apply only if the discharge is by a qualified person.

(B) Qualified person.--For purposes of subparagraph (A), the term "qualified person" has the meaning given to such term by section 49(a)(1)(D)(iv); except that such term shall include any Federal, State, or local government or agency or instrumentality thereof.

(2) Qualified farm indebtedness.--For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if -

(A) In general.--The amount excluded under subparagraph (C) of subsection (A)(1) shall not exceed the sum of--

(i) the adjusted tax attributes of the

taxpayer, and

(ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

(B) Adjusted tax attributes.--For purposes of subparagraph (A), the term "adjusted tax attributes" means the sum of the tax attributes described in subparagraphs (A), (B), (C), (D), (F), and (G) of subsection (b)(2) determined by taking into account $3 for each $1 of the attributes described in subparagraphs (B), (C), and (G) of subsection (B)(2) and the attribute described in subparagraph (F) of subsection (B)(2) to the extent attributable to any passive activity credit carryover.

(C) Qualified property.--For purposes of this paragraph, the term "qualified property" means any property which is used or is held for use in a trade or business or for the production of income.

(D) Coordination with insolvency exclusion.--For purposes of this paragraph, the adjusted basis of any qualified property and the amount of the adjusted tax attributes shall be determined after any reduction under subsection (B) by reason of amounts excluded from gross income under subsection (a)(1)(B).

26 U.S.C. § 1366. Pass-thru of items to shareholders

(a) Determination of shareholder's tax liability.--

(1) In general. -- In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's--

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) Nonseparately computed income or loss defined.-- For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) Character passed thru.--The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) Gross income of a shareholder.--In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) Special rules for losses and deductions.--

(1) Cannot exceed shareholder's basis in stock and debt.--The aggregate amount of losses and deductions taken into

account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of--

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) Indefinite carryover of disallowed losses and deductions.--Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(3) Carryover of disallowed losses and deductions to post-termination transition period.--

(A) In general.--If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) Cannot exceed shareholder's basis in stock.--The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) Adjustment in basis of stock.--The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(D) At-risk limitations.--To the extent that any increase in adjusted basis described in subparagraph (B) would have increased the shareholder's amount at risk under section 465 if such increase had occurred on the day preceding

the commencement of the post-termination transition period, rules similar to the rules described in subparagraphs (A) through (C) shall apply to any losses disallowed by reason of section 465(a).

(e) Treatment of family group.--If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) Special rules.--

(1) Subsection (a) not to apply to credit allowable under section 34.--Subsection (a) shall not apply with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels.

(2) Treatment of tax imposed on built-in gains.--If any tax is imposed under section 1374 for any taxable year on an S corporation, for purposes of subsection (a), the amount so imposed shall be treated as a loss sustained by the S corporation during such taxable year. The character of such loss shall be determined by allocating the loss proportionately among the recognized built-in gains giving rise to such tax.

(3) Reduction in pass-thru for tax imposed on excess net passive income.--If any tax is imposed under section 1375 for any taxable year on an S corporation, for purposes of subsection (a), each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of such tax as--

(A) the amount of such item, bears to

(B) the total passive investment income for the taxable year.

26 U.S.C. § 1367. Adjustments to basis of stock of shareholders, etc.

(a) General rule.--

(1) Increases in basis.--The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis.--The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

(b) Special rules.--

(1) Income items.--An amount which is required to be included in the gross income of a shareholder and shown on his

return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness.--

(A) Reduction of basis.--If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis.--If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d).--This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock.--

(A) In general.--If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis.--The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the

decedent.

Supreme Court, U.S.
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(2)

No. 99-1693

In the Supreme Court of the United States

WILLIAM C. WITZEL AND GENE E. WITZEL,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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9 pp

QUESTION PRESENTED

Petitioner William C. Witzel was the sole shareholder in a Subchapter S corporation that obtained a discharge of indebtedness in a bankruptcy proceeding. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred during a bankruptcy proceeding, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(A). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioner as the shareholder of the Subchapter S corporation, thereby increasing his basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing him to deduct losses he previously was unable to deduct because he had exhausted his basis by prior deductions.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is reported at 200 F.3d 496. The memorandum opinion of the Tax Court (Pet. App. 8a-11a) is unofficially reported at 77 T.C.M. (CCH) 1487.

JURISDICTION

The judgment of the court of appeals was entered on January 18, 2000. The petition for a writ of certiorari was filed on April 17, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. During the 1993 taxable year, petitioner William C. Witzel was the sole shareholder of Water Products Co. of Illinois, Inc., a corporation that had elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 9a. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

In 1991, Water Products filed a petition for relief under Chapter 11 of the Bankruptcy Code. Pet. App. 9a. In 1992, debts of that corporation totaling $5,404,323 were discharged by the bankruptcy court. *Ibid.* The discharge of these debts would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) but for the fact that the discharge occurred in a bankruptcy proceeding. Because the discharge occurred in a bankruptcy proceeding, it was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs in a title 11 case." 26 U.S.C. 108(a)(1)(A).

b. Although Section 108 of the Code thus specifies that discharge of indebtedness is *not* an item of income when the discharge occurs in a federal bankruptcy proceeding, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of

Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioner William Witzel had previously deducted losses representing his entire basis in the corporate stock. At the time the indebtedness of the Subchapter S corporation was discharged in 1992, petitioner would thus be allowed further deductions from the corporation's losses only if his basis in the stock of the corporation were somehow increased.[1]

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[1] The losses of the corporation incurred prior to and during 1992, which petitioner had been unable to deduct because he had exhausted his basis in the stock of the corporation, are described as "suspended" losses and are carried into future years. They may be

Petitioner asserts that the additional basis that would allow him to take further deductions from prior corporate losses can be found in the discharge of indebtedness "income" of the corporation in 1992. He contends that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) which increases his basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. Petitioner (and his wife on their joint return) thus claimed a loss deduction of $2,549,251 for the 1993 taxable year that reflected a carry forward of the losses incurred by Water Products in prior years. Pet. App. 10a.

The Commissioner of Internal Revenue determined that petitioner was not entitled to increase his stock basis by the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the claimed deductions and asserted a deficiency in tax against petitioners for the 1993 taxable year. Pet. App. 22a-24a.

2. Petitioners filed a petition in Tax Court to contest the Commissioner's determination. Pet. App. 18a-21a. The Tax Court held that the discharge of indebtedness that occurred during the bankruptcy proceeding did not increase petitioner's basis in the corporate stock and that the asserted deductions were therefore properly denied. *Id.* at 8a-11a. In reaching that conclusion, the court relied on the reviewed Tax Court decision in *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999), in which the court unanimously held that an amount excluded from an insolvent

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deducted in future years only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

Subchapter S corporation's gross income under Section 108 does not increase a shareholder's basis in the corporate stock. Pet. App. 10a-11a.

3. The court of appeals affirmed. Pet. App. 1a-6a. The court noted that petitioners were seeking a double tax benefit from the amount excluded from Water Products' gross income—nonpayment of tax on the excluded amount plus use of that amount to obtain deductions for otherwise nondeductible suspended losses. *Id.* at 3a. The court concluded that it was "preferable" to interpret Section 108 to preclude that result. *Id.* at 4a.

DISCUSSION

This case presents the same question presented in *Gitlitz* v. *Commissioner*, No. 99-1295, in which this Court granted the petition for a writ of certiorari on May 1, 2000. The petition in this case should therefore be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz*.[2]

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[2] We have provided herewith to petitioners a copy of the brief filed on behalf of the Commissioner in response to the petition for a writ of certiorari in the *Gitlitz* case.

CONCLUSION

The petition for a writ of certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz* v. *Commissioner*, No. 99-1295.

Respectfully submitted.

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